Bankruptcy Courts May Be Budding Open To Cannabis Cases

By **Bethany Simmons and Noah Weingarten** (August 19, 2024)

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While bankruptcy courts throughout the country have historically been resistant to permitting debtors with connections to the cannabis industry to avail themselves of the protections of federal bankruptcy law, a recent trend may be emerging in which bankruptcy courts authorize the opposite and permit these debtors to remain in bankruptcy.

Historical Resistance of Bankruptcy Courts to Cannabis Bankruptcy Cases

The tension arises because, while cannabis may be legal to possess and consume under the laws of certain states, cannabis remains a prohibited Schedule 1 drug under the Federal Controlled Substances Act.

For this reason, the U.S. Trustee's Office — a watchdog that is an arm of the U.S. Department of Justice — has typically sought the dismissal of bankruptcy cases in which the debtor is connected to the cannabis industry for cause on the basis that a debtor that violates federal law should not be able to avail itself of the protections of federal bankruptcy law.

Bankruptcy courts have also been concerned with obligating a Chapter 7 trustee, who is charged with liquidating a debtor's assets, with having to operate a business and sell assets that are potentially illegal to operate or sell.

Potential Recent Trend Toward Permitting Cannabis-Industry Bankruptcies?

Despite that historical resistance, at least two bankruptcy courts have kept their doors open to cannabis-related debtors.

In In re: The Hacienda Co. LLC, decided in 2023, the U.S. Bankruptcy Court for the Central District of California denied a motion to dismiss the Chapter 11 bankruptcy case despite finding that the marijuana-industry debtor was engaged in an ongoing, postpetition violation of the CSA.

In In re: Callaway this June, the U.S. Bankruptcy Court for the Northern District of California denied a motion to dismiss a Chapter 7 bankruptcy case over the request of the U.S. Trustee's Office, which was joined by the Chapter 7 trustee.

Both of these decisions denied the respective motions to dismiss on different grounds.

However, the reasoning and logic may provide guidance to prospective bankruptcy debtors and practitioners in strategizing for a potential bankruptcy filing where the debtor has connections to

the cannabis industry.

Facts of Hacienda

Prepetition, the corporate debtor in Hacienda was in the business of wholesale manufacturing, packaging, and distribution of cannabis products to dispensaries.

The debtor ceased its operations and transferred its assets to a third party whose sole business was cannabis growth and sales. In exchange, the debtor received shares in the third-party cannabis distributor.

After the debtor filed its Chapter 11 bankruptcy case, the debtor indicated its intent to propose a plan that called for the sale of the debtor's shares in the third party.

Thereafter, the U.S. Trustee's Office filed its first motion to dismiss the case, arguing that the debtor was engaged in the sale of cannabis products, or a conspiracy to do so, in violation of the Controlled Substances Act.

No Adoption of "Zero Tolerance" Policy to Illegal Acts

Among other things, the court found that even if the U.S. Trustee's Office could establish a CSA violation, Congress did not adopt a zero tolerance policy for any illegality, and "a violation of the CSA [alone]" was not enough to warrant dismissal of the bankruptcy case.

The court observed that requiring dismissal every time that a debtor was engaged in postpetition criminal activity could warrant dismissal for "the vast majority of all bankruptcy cases."

The court provided examples of potential bankruptcy debtors who were engaged in postpetition violations of law, where dismissal would not be warranted.

In large bankruptcies, including Pacific Gas & Electric Co., Enron Corp. and Bernie Madoff, the debtors were engaged in illegal activities postpetition. Restaurants and landlords "have at least some ongoing level of violations of health and safety regulations."

Individual consumer debtors with financial difficulties may have difficulty paying parking fines. That failure alone could warrant denial of the bankruptcy forum.

Thus, the court concluded that if all of the foregoing examples were sufficient cause for mandatory dismissal, many bankruptcy cases would be dismissed.

Court Adheres to Original Ruling After a "Probable" Pre- and Postviolation of CSA

Later in the same case, the U.S. Trustee's Office filed its second motion to dismiss, based on additional arguments tending to show pre- and postpetition CSA violations.

While the court observed that there were "probable" pre- and postpetition violations of the CSA, the court adhered to its initial ruling, finding that, while the debtor was still involved in ongoing violations of federal law, the U.S. Trustee's Office had not shown "how [the] Debtor's orderly postpetition liquidation of its stock in [the third-party] offends the principles in the Bankruptcy Code in any way, let alone establishes sufficient 'cause' to mandate dismissal."

The court also reemphasized that Congress did not adopt a zero tolerance policy for illegality, especially "when the real victims would be innocent creditors." The court noted, by way of example, that the bankruptcy code subordinates payment of governmental fines to the payment of creditor claims.

The court also observed, again, that many common types of business bankruptcies, such as restaurants and landlords, typically do involve some ongoing violations of health and safety laws. And even in large bankruptcies with ongoing violations of law present, the debtors did not "instantaneously cease all criminal acts the moment they filed their bankruptcy petitions."

Rather, the court noted that it can take time postpetition to attempt to divest the debtor from any connection with ongoing illegality.

Facts of Callaway

The debtor in Callaway owned an ownership interest in two retail cannabis dispensaries and was entitled to distributions from one of the two dispensaries "in the ballpark" of $700,000.

The U.S. Trustee's Office and a creditor filed separate motions to dismiss for cause because "the assets of the estate are comprised of or derived from cannabis."

The U.S. Trustee Office more specifically argued that the "Debtor 'possesses and controls an interest in cannabis assets and business ventures that are in violation of the Controlled Substances Act ... and which a chapter 7 trustee cannot lawfully administer.'"

Essentially, the U.S. Trustee argued, the "chapter 7 trustee cannot lawfully administer assets in violation of the CSA, and continuation of the case would force the chapter 7 trustee into such a position."

The Chapter 7 trustee also joined in both motions and argued "although a Chapter 7 Trustee would like nothing more than to be able to administer an asset case, it is clear that he would be subject to prosecution in any attempt to administer the assets of this particular estate."

Distinguishing Chapter 7 from Chapter 11 Cannabis Cases

The Callaway court noted that many of the decisions dismissing cannabis cases arise in Chapter 11 or Chapter 13.

In those cases, the courts dealt with "the actual or anticipated postpetition conduct expected of the debtor, the debtor-in-possession or the chapter 13 trustee, almost entirely in the context of use of income or funds from businesses that are in violation of the CSA during chapter 11 reorganization or administration of a chapter 13 plan."

A Chapter 7 case presents a different and difficult issue: "whether the bankruptcy court and the court appointed bankruptcy trustee should play a role in the continued administration of income derived from a marijuana business."

Distinguishing Debtor From Marijuana Businesses

In denying the motions to dismiss, the Callaway court recognized that the debtor was considered "separate from the entities that engage in the marijuana business," and, therefore, found that the trustee was not "in danger of having to administer the actual tangible marijuana assets held by those businesses."

Specifically, under applicable California law, corporate shareholders do not "own the corporate property nor the corporate earnings." Rather, a shareholder "simply has an expectancy interest in each, and he becomes the owner [upon a liquidation action or declaration of a dividend]."

Sale of Ownership Interest in Cannabis Dispensaries May Not Directly Violate the CSA

As to the sale of the cannabis dispensaries, the court found that the "sale of the ownership of [the dispensary], including its name, goodwill customer list and other intangibles ... do not on their face appear to implicate the CSA." Rather, "any potential sale of a membership interest in an LLC is just that – the sale of an ownership interest whose rights are bundled in applicable articles of incorporation or operating agreements."

Accordingly, the court held that the "possible sales of interests in LLCs, enforcement of LLCs' contractual rights and sale of other intangibles related to marijuana" are "not directly implicated by the language of the CSA [and] are not sufficient for this court to find cause to dismiss an otherwise eligible individual debtor's chapter 7 case."

A Claim of Entitlement From Cannabis Dispensary May Not Directly Violate CSA

As for the debtor's claim for distribution from one of the two dispensaries, the court observed that just like a sale of an LLC membership interest is not necessarily the proceeds of a marijuana business, so too, "a claim against fellow LLC owners for owed proceeds are not necessarily a claim for the profits of a marijuana business."

Rather, it is "a claim for the entitlements owed to the holder of ownership interests."

The court also noted that "[w]hile it is true that realizing profits from a marijuana business is

prohibited by the CSA, there is nothing presented by the parties, nor discovered by the court, that suggests that monetizing an intangible ownership interest is the equivalent of profiting from a marijuana business."

The court analogized liquidating the intangible claim to monetizing the domain name of a marijuana business, observing: "no party has suggested, nor does the court know of a reason, why the trustee would violate the CSA or any other law were he to offer to sell, and actually sell, such intangible assets of the estate such as domain names."

Takeaways

Hacienda and Callaway provide persuasive authority for a bankruptcy court to retain a bankruptcy case that involves a debtor with connections to the cannabis industry.

However, if a bankruptcy court refuses to dismiss a cannabis-related bankruptcy case, it will likely have to confront a host of potential issues that are unique to this type of debtor whether the debtor is seeking to reorganize or liquidate, including the following.

Debtors are required to file schedules under penalty of perjury that list their assets. Because the assets — cannabis — are illegal under federal law, the bankruptcy schedules are potentially inculpatory against the debtor and raise interesting Fifth Amendment issues against self-incrimination.

Likewise, if a debtor's schedules list cannabis as an illegal asset, the federal government could potentially seize those assets under Title 11 of the U.S. Code, Section 362(b)(4)'s police power exception to the automatic stay. If assets were to be seized postpetition, then the estate would be depleted and creditors would suffer by the diminution in assets that would be available for a reorganization or sale.

Debtors engaged in the cannabis industry are typically cash-heavy businesses. The bankruptcy code requires debtors to maintain their cash in accounts approved by the U.S. Trustee's Office.

However, because the debtor's cash may constitute tainted proceeds from an illegal activity, that fact may pose a complication to a bank accepting the deposit of these funds.

In a Chapter 11 case reorganization case, the estate may make a distribution to creditors in the form of equity. This could require creditors either to accept an ownership interest in a business that is illegal under federal law or to forego recovering on their claim.

Debtors and their estates are permitted to bring avoidance actions — e.g., fraudulent transfer and preference actions and other similar actions to "claw back" unauthorized postpetition transfers — and recover the assets that were transferred or the value of those assets. In a cannabis case, it is unclear if the estate will be permitted to recover cannabis or only the monetary equivalent.

There is no clear sense yet of the answer to these issues and future case law will provide guidance on how courts will eventually decide these issues.

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